

From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

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Heads Up for the 2018 Proxy Season: ISS Updates Proxy Voting Policies – Board Composition, Accountability and Responsiveness in the Spotlight

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ISS released its updated proxy voting policies effective for annual meetings held on or after February 1, 2018, which are available [here](#). We previewed ISS's proposed voting policy changes in our Alert available [here](#). The policy changes include several new policies, as well as codification of existing policies focusing primarily board composition, accountability and responsiveness. In this Alert we provide guidance for U.S. public companies on addressing these developments and practical tips for “*What to do Now?*” Companies should become familiar with these new policies, especially those that could implicate ISS voting recommendations for their upcoming director elections, and continue to engage with their institutional investors on important governance matters.

Key Policy Changes

- Social and Environmental Issues
 - Board Diversity
 - Gender Pay Equity Shareholder Proposals
 - Climate-Risk Shareholder Proposals
- Board Responsiveness and Independence
 - Engagement
 - Independence
- Director and Executive Compensation
 - Excessive Non-Employee Director Compensation
 - Problematic Compensation Practices
 - Problematic Pledging
- Board Accountability: Defensive Measures
 - Poison Pills
 - Removal of Shareholder Discretion on Classified Boards
 - Restrictions on Binding Shareholder Proposals
- Voting Capital / Restructuring
 - SPACs

Focus on Social and Environmental Issues Continues

1. Diversity in the Spotlight

ISS Principle on Diversity – *NEW*

ISS applies four fundamental principles in formulating its voting recommendation on director nominees: Accountability, Responsiveness, Composition and Independence. For the upcoming season, ISS has added an express statement regarding the benefits of diversity in the board room by including in the Composition principle that boards “should be sufficiently diverse to ensure consideration of a wide range of perspectives.” While the policy appears to leave room for boards to interpret “diversity” in a manner that is relevant and appropriate for their companies, ISS’s policies primarily focus on gender and racial diversity.

Diversity – *NEW*

ISS will now put a spotlight on boards that lack gender diversity. While this will not trigger an adverse vote recommendation in 2018, ISS has added this policy based on the response from 69% of investor respondents to ISS’s 2017-2018 Governance Principles Survey that they would consider it problematic if there were no female directors on a public company board.

2. Gender Pay Gap Shareholder Proposals - *NEW*

ISS has adopted a new case-by-case policy in response to the increasing number of shareholder proposals requesting that companies report whether a gender pay gap exists, and if so, what measures the company is taking to eliminate such gap. Over the last three years, proponents have targeted technology, financial services, insurance, healthcare and telecommunications companies – industries in which shareholder proponents assert women are underrepresented. As gender-based issues and initiatives continue to garner attention, we expect that pay equity will remain a focus for shareholders and extend to other industries.

The new policy provides that the following factors will be considered in ISS’s case-by-case assessment:

- The company’s current policies and disclosure related to both its diversity and inclusion policies and practices, and its compensation philosophy and fair and equitable compensation practices;
- Whether the company has been the subject of recent controversy or litigation related to gender pay gap issues; and
- Whether the company’s reporting regarding gender pay gap policies or initiatives is lagging its peers.

3. Climate Change Risk Shareholder Proposals – *REVISED*

ISS has revised its policy on how it evaluates shareholder proposals which expressly seek transparency around a company’s disclosure of financial, physical, or regulatory risks related to climate change, or around the company’s *processes* to identify, measure, and manage such risks. The changes to ISS’s factors were informed by the recommendations of the Task Force on Climate-related Disclosures (TCFD) released in the summer of 2017.

ISS will consider the following factors in its case-by-case assessment:

- Whether the company already provides current, publicly-available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- The company’s level of disclosure compared to that of industry peers; and

- Whether there are significant controversies, fines, penalties, or litigation associated with the company's climate change-related performance.

Board Responsiveness and Independence

4. Board Engagement on Say-on-Pay, Say-on-Pay Frequency Results – *REVISED*

In circumstances where a company's previous say-on-pay proposal received less than 70% of the votes cast at the prior annual meeting, ISS's current policy is to consider the following factors in formulating its voting recommendation on the election of the members of the compensation committee (or the entire board in exceptional circumstances) and the say-on-pay proposal:

- The company's response, including disclosure of any engagement efforts with major institutional investors;
- Other recent compensation actions taken by the company;
- Whether the issues raised are recurring or isolated;
- The company's ownership structure; and
- Whether the support level was less than 50%, which would warrant the highest degree of responsiveness.

ISS has added the following factors to its evaluation of the board's or the compensation committee's responsiveness to a say-on-pay proposal that received less than 70% support:

- The timing and frequency of engagement with shareholders and whether independent directors participated;
- Disclosure of the specific concerns raised by dissenting shareholders that led to the say-on-pay opposition; and
- Disclosure of specific and meaningful actions taken to address shareholders' concerns.

The additional details requested by ISS may signify its dissatisfaction with the quality of the disclosure on companies' engagement efforts. In order to assess responsiveness, ISS is now looking for more specificity as to when and how often the company and/or independent directors are engaging with shareholders as well as the particular actions that were taken in response. General or broad disclosure about interactions with shareholders may no longer be sufficient.

ISS also clarified that it would evaluate whether a company adopted a frequency on the say-on-pay vote less than that supported by a plurality of the votes cast.

5. Categorization of Directors – *REVISED*

In the U.S., ISS has classified directors into three categories: (i) Inside Directors; (ii) Affiliated Outside Directors and (iii) Outside Directors. ISS now has changed this nomenclature in order to harmonize the characterization of directors across global markets. There will be no impact on vote recommendations. Going forward, these three categories will be: (i) Executive Directors; (ii) Non-Independent, Non-Executive Directors, and (iii) Independent Directors. ISS has added a new sub-category of "Controlling/Significant Shareholder," which was previously included under "Inside Director" category, but has been moved to the "Non-Independent, Non-Executive Director" category and covers beneficial owners of more than 50% of the company's voting power.

Director and Executive Compensation Related Updates

6. Excessive Non-Employee Director Compensation – *NEW*

Starting in 2019, ISS may recommend voting against or withholding from the compensation committee (or other committee responsible for approving/setting non-employee director compensation) if there is a pattern – i.e. two or more years – of excessive non-employee director compensation without disclosure of a compelling rationale. This new policy is meant to target companies that are outliers relative to their peers and the broader market and to hold accountable directors who approve excessive pay. The new policy is not expected to impact director voting recommendations in 2018.

As we discussed in our Alert available [here](#), last year ISS adopted a framework for evaluating management proposals to ratify non-employee director compensation as companies began to submit their director compensation programs to a shareholder vote in response to several high-profile lawsuits regarding excessive non-employee director compensation.

7. Problematic Compensation Practices – *REVISED*

ISS has modified problematic practices that will result in an against or withhold recommendation in the election of compensation committee members or, if the company also did not include a say-on-pay vote on the ballot, the entire board.

The five problematic factors are:

- Significant misalignment between CEO pay and company performance;
- Significant problematic pay practices (as set forth in ISS’s FAQ #48 available [here](#));
- The board exhibits a significant level of poor communication and responsiveness to shareholders;
- The company fails to include a say-on-pay proposal; and
- The company fails to include a say-on-pay frequency proposal.

The last two factors are new and replace two previous factors which focused on transfers of stock options and burn rate commitment. ISS noted that non-shareholder approved transfers of stock options are so rare that a separate policy is not necessary; however, if such a transfer were to occur it would be treated as a problematic pay practice. Similarly, ISS stopped considering three-year burn commitments in connection with the introduction of the Equity Plan Scorecard and the last three-year burn rate commitments ended in fall 2017, so the policy could be removed.

ISS’s new “say-on-pay” factor codifies existing practice where ISS will recommend against the election of compensation committee members if a company does not have a say-on-pay proposal on its ballot and does not have a legal basis for its exclusion (i.e., the company is not an emerging growth company, foreign private issuer or non-SEC registrant). ISS’s new “say-on-pay frequency” factor resulted from ISS’s efforts to remind those companies that failed to include the proposal at least once every six years. While most companies re-filed their proxy statements to include such proposal, some did not and ISS recommended against or to withhold from members of the compensation committee at such companies.

Although not part of this policy, relevant for the first time this year, ISS will note pay ratio disclosures this year; however, such disclosures will not be considered when evaluating recommendations on compensation committee members or the “say-on-pay” vote in 2018.

8. Problematic Pledging of Company Stock – *NEW*

ISS has codified its policy to recommend against the committee responsible for risk oversight, or the full board, where a significant level of pledged company stock by executives or directors raises concerns. ISS also clarified the factors that it considers when determining whether pledging is problematic as follows:

- Proxy statement disclosure of an anti-pledging policy that prohibits future pledging activity;
- The magnitude of aggregated pledged shares in relation to share outstanding, market value and trading volume;
- Disclosure of progress (or lack thereof) toward reducing the magnitude of aggregate pledged shares over time;
- Proxy statement disclosure that shares are subject to stock ownership and holding guidelines; and
- Any other relevant factors.

See also ISS FAQ's #29-31 available [here](#) for guidance on how ISS evaluates "significant" pledging.

Board Accountability: Defensive Measures

9. Poison Pills – *REVISED*

ISS has clarified its policy on how it evaluates long-term and short-term poison pills. ISS will recommend against or withhold from the entire board of directors (except new nominees, who will be considered on a case-by-case basis) of companies with a long-term (greater than one year) poison pill that was not approved by shareholders or if the board makes a material adverse change to an existing poison pill, including, but not limited to, extension, renewal, or lowering the trigger, without shareholder approval.

Short-term poison pills with a duration of one year or less that were not approved by shareholders will continue to be evaluated on a case-by-case basis, taking into account the disclosed rationale for adoption, and other relevant factors, such as a commitment to put a renewal up to a shareholder vote, rather than on the company's governance practices and track record as is the current policy. ISS appears to recognize that a short-term pill may provide the board with a valuable tool to maximize shareholder value in the face of an opportunistic offer.

Directors on boards that had a poison pill in place prior to 2009 and were grandfathered by the previous ISS policy will no longer be exempt from ISS's negative recommendation. ISS will also no longer distinguish between annually elected and staggered boards, so all incumbent directors up for election at these companies will face negative recommendations each time they are on the ballot. As a result, directors at approximately 90 companies that adopted or renewed 10-year pills and an additional 50 companies with annually-elected boards will be affected by this policy change in 2018.

10. Removal of Shareholder Discretion on Classified Boards – *NEW*

Under a new ISS policy, ISS will recommend against or withhold from the entire board of directors (except new nominees, who will be considered on a case-by-case basis), if the company has opted into, or failed to opt out of, a state law requiring a classified board. ISS's policy change means that it will no longer permit companies to justify having a classified board based upon the applicable laws of their home jurisdiction. ISS notes that shareholders have limited ability to challenge staggered boards at companies that rely on state law because such shareholder proposals are excludable under Rule 14a-8(i)(2) because they contradict state law. Specifically, ISS has been recommending against boards of approximately 20 Indiana-incorporated companies and one Iowa-incorporated company, which have yet to opt out of the respective state's law that requires a classified board.

11. Restricting Binding Shareholder Proposals – *REVISED*

ISS has slightly modified its policy concerning binding shareholder proposals. ISS will generally recommend against or withhold from members of the governance committee to extent that *any* of a company's governing documents impose undue restrictions on shareholders' ability to amend the company's bylaws (e.g. charter, bylaws, articles of association, not just the company's bylaws).

Voting Capital/Restructuring

12. SPACs – *New*

Recently there has been a notable increase in the number of special purpose acquisition companies (SPACs) formed for the purpose of effectuating an initial business combination. SPACs have a limited duration under their organizational documents, which typically specify that they have 18 months to sign a definitive agreement for a business combination and two years from the time of their to consummate it. If the business combination is not completed within this timeframe, SPACs must either extend their lifespans or dissolve. SPACs that have neither proposed nor consummated a business combination and are nearing their deadlines often request extensions of their deadlines by way of amendments to their charters and trust agreements. ISS has adopted a new policy to provide guidance on the factors that ISS will consider when determining whether to recommend in favor a SPAC's management proposal seeking an extension.

Specifically, ISS will evaluate:

- The length of the extension request;
- Whether there is a transaction pending or the stage of the SPAC's acquisition process;
- Any additional incentives provided to the non-redeeming shareholders; and
- Whether there have been prior extension requests.

What To Do Now?

- **Assess Board Composition, Skills and Diversity and Enhance Disclosure.** As ISS's policy changes indicate, institutional investors continue to pay close attention to board composition, individual directors' competencies and diversity. Investors such as Blackrock, State Street, and Vanguard have publicly announced boardroom gender diversity as an engagement priority. In addition, initiatives such as the NYC Comptroller's Boardroom Accountability Project 2.0, which we discussed [here](#), focus on enhancing disclosure of board composition through a skills matrix. These initiatives are driving heightened attention to the diversity and competencies of the board as whole. Companies should refresh disclosure relating to board composition, skills and diversity and consider whether the skills, backgrounds and diversity of each director and the collective experience of the board is presented clearly.
- **Pay Close Attention to Shareholder Proposals on Social and Environmental Issues.** In 2018 we expect that institutional investors will continue to take greater stewardship of the social, environmental and governance aspects of their investments. Companies should be prepared for shareholder proposals on these issues and should understand the positions of their shareholders in order to inform how they respond. Companies are also reminded that requests for no-action relief seeking exclusion of proposals on the basis of the ordinary business exception (Rule 14a-8(i)(7)) or the economic relevance exception (Rule 14a-8(i)(5)) must include the board's analysis, as discussed in recent blog posts, available [here](#) and [here](#).
- **Review and Enhance Disclosure of Your Shareholder Engagement Program.** ISS's request for specific information concerning engagement by the board or the compensation committee on executive compensation may demonstrate its dissatisfaction with the quality of companies' disclosure on engagement. Generally, companies may no longer broadly or simply state that they have shareholder engagement programs in order to get credit from ISS with respect to their engagement programs. ISS appears to be looking for detailed disclosure about meaningful engagement programs resulting in specific responses to shareholder feedback.
- **Review and Enhance Disclosure of Director Compensation.** Boards should pay close attention to and work with their compensation consultants to assess non-employee director compensation, especially relative to their peers, and disclose the rationale for these compensation decisions in the company's proxy statement.
- **Consider Shareholder Approval or Ratification of Poison Pills.** Companies should consider the current status of any existing poison pill and the context under which it was adopted to determine whether the benefit of the pill outweighs the negative recommendations in director elections. Companies considering adopting a short-term pill should prepare to disclose the rationale for such adoption.
- **Review and Verify QualityScore Report.** Companies should carefully review and verify their QualityScore report. The verification period is open from November 13 through 8pm Eastern time on November 28. During this period companies may verify information contained in their corporate governance profile through the data verification site on Governance Analytics available [here](#).

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